No. 83-1855 (2)

In the Supreme Court of the United States

OCTOBER TERM, 1984

JAMES S. GARVEY, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTION PRESENTED

Whether the petitioners are entitled to treat the receipt of an unsecured private annuity in exchange for appreciated property as an open transaction under *Burnet* v. *Logan*, 283 U.S. 404 (1931), thereby deferring recognition of gain resulting from the exchange until they have recovered their basis in the property transferred, or whether they should be required to report the gain ratably as each of the annuity payments is received.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-10a) is reported at 726 F.2d 1569. The opinion of the Claims Court (Pet. App. 11a-52a) is reported at 1 Cl. Ct. 108.

JURISDICTION

The judgment of the court of appeals (Pet. App. 54a) was entered on February 7, 1984. On April 27, 1984, the Chief Justice extended the time for filing a petition for a writ of certiorari to May 28, 1984. The petition was filed on May 14, 1984. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. On June 1, 1969, each petitioner transferred appreciated property to a corporation in return for the corporation's unsecured promise to pay a life annuity to the transferor (Pet. App. 34a). The amount of each annuity was

calculated by dividing the fair market value of the property (as independently appraised) by the appropriate life annuity factor prescribed by the Commissioner for valuing annuities for estate and gift tax purposes (Treas. Reg. § 20.2031-7(f)). Pet. App. 34a.[1]

Each petitioner reported his or her receipt of annuity payments on tax returns for the years in suit in accordance with the computation contained in Rev. Rul. 74, 1969-1 C. B. 43 (Pet. App. 37a). Under that Revenue Ruling, the full yearly annuity payment is considered gross income and then a portion is excluded from income pursuant to ratios prescribed by Section 72(b) of the Code.[2] That exclusion ratio is computed by dividing the basis of the transferred property by the total expected return from the annuity contract. This exclusion ratio is then multiplied by the annuity payment to obtain the annual exclusion under Section 72. The capital gain on the transfer of the property in exchange for the annuity is recognized ratably over the annuitant's life expectancy as given by the expected return

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[1]The annuities paid to each of the petitioners were as follows (Pet. App. 34a):

Annuitant (age)	Basis of Property Transferred	Fair Market Value on June 1, 1969	Annuity Factor	Annuity
Willard W. Garvey (49)	$2,107,154	$7,628,231	15.1831	$502,416
Jean K. Garvey (47)	60,979	222,062	15.8388	14,020
James S. Garvey (46)	2,881,976	8,457,252	16.1596	523,358
Shirley F. Garvey (45)	32,304	167,550	16.4754	10,170
H. Bernerd Fink (60)	302,566	1,050,770	11.3369	92,686
Ruth G. Fink (52)	1,695,143	6,717,185	14.1678	474,116
George A. Lincoln (47)	64,853	336,369	15.8388	21,237
Olivia G. Lincoln (43)	1,682,436	6,848,261	17.0913	400,685

[2]Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended (the Code).

multiple used in calculating the exclusion ratio. The balance of the annuity payment is taxable as ordinary income.[3] Rev. Rul. 74, *supra*.

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[3]The computations under Rev. Rul. 74, *supra*, can be illustrated by the annuity payable to petitioner Willard W. Garvey as follows (Pet. App. 34a):

Step 1. Compute the exclusion ratio for a male annuitant, age 49, using the expected return multiple from Table I of Treasury Reg. § 1.72-9:

$$\frac{2{,}107{,}154}{502{,}416 \times 26.3} = .1594693$$

Step 2. Calculate the annual exclusion:

502,416 x .1594693 = 80,120

Step 3. Calculate the gain on the transf..:

Fair market value on June 1, 1969	$7,628,231
Less: Basis	2,107,154
Total gain	$5,521,077

Step 4. Determine ratable share of gain to be recognized each year:

$$\frac{5{,}521{,}077}{26.3} = 209{,}927$$

Step 5. Determine ordinary income:

Annuity payment	$502,416
Less: Annual exclusion	80,120
Balance	422,296
Less: Capital gain recognized	209,927
Ordinary annuity income	$212,369

After the petitioners filed their returns, they filed timely claims for refund, asserting that the exchange of property for an unsecured private annuity was an "open transaction" within the meaning of *Burnet* v. *Logan*, 283 U.S. 404 (1931) — because the receipt of each payment was contingent on the survival of the annuitant and on the continuing solvency of the obligor — and hence that the petitioners had no taxable gain from the exchanges until they had fully recovered their respective bases in the property (Pet. App. 37a). The Commissioner disallowed the petitioners' claims for refund, and the petitioners filed suit in the United States Court of Claims (Pet. 3).

2. The Claims Court[4] rejected petitioners' contention that the open transaction doctrine of *Burnet* v. *Logan* applies to the taxation of the gain realized on the transfer of property in exchange for a private annuity (Pet. App. 34a-46a). The court pointed out that Congress had revised the statutory scheme in 1954, long after *Burnet* v. *Logan* was decided. Under Section 72 of the Code, an annuitant's tax burden is spread evenly through his lifetime, instead of subjecting him to a sharp increase in tax liability several years after the annuity starting date, when he recovers his investment in the annuity contract and all subsequent annuity payments become fully taxable (Pet. App. 41a-44a). The court concluded that the provisions of Rev. Rul. 74, which require the petitioners to report the gains realized on the purchase of the private annuities ratably over their life expectancies, are more in keeping with the current statutory scheme of annuity taxation than is petitioners' proposal to defer taxation until they have recovered their respective investments in their annuity contracts (Pet. App. 44a-45a).

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[4] The cases were transferred to the Claims Court on October 1, 1982, pursuant to the Federal Courts Improvement Act of 1982, Pub. L. No. 97-164, §§ 402 and 403 96 Stat. 57-58.

3. The court of appeals affirmed. It held that Section 72 displaced the open transaction doctrine in favor of a proration system in the taxation of annuity income, and that the government's method of computation provides an actuarially sound procedure for prorating gain (Pet. App. 8a-9a). The court pointed out (*id.* at 9a) that this method of computation, like the exclusion ratio computation prescribed by Section 72(b), is "based on the rational expectation that over time and throughout the aggregate taxpaying populace individual inequities will average out and the general revenue will be protected."

ARGUMENT

The judgment of the court of appeals is correct. It does not conflict with the decision of this Court in *Burnet* v. *Logan, supra,* or with any decision of any other court of appeals. Accordingly, further review is not warranted.

1. Petitioners contend (Pet. 5-13) that *Burnet* v. *Logan* requires the government to treat an exchange of appreciated property for a private annuity as an open transaction on which no gain is recognized to the annuitant until he has recovered the full amount of his basis in the property. Petitioners' interpretation of the open transaction doctrine recognized by this Court in *Burnet* v. *Logan* is erroneous. Nothing in the opinion in that case requires the government to disregard well established principles of actuarial science and treat the exchange of appreciated property for a private annuity as an open transaction, thereby permitting petitioners to enjoy the benefits of a fixed stream of income, while deferring taxation on the exchange for a substantial period of time.[5]

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[5]In their brief on appeal (at 32, 34), petitioners stated that they did not dispute the amount of ordinary income they were required to report each year as annuity income under Section 72, nor did they dispute the total amount of capital gain that they would be required to report

In *Burnet* v. *Logan*, 283 U.S. at 409-410, the taxpayer transferred her interest in an iron mine to a steel company in exchange for a royalty of 60 cents per ton of iron ore extracted from the mine and allocable to her interest. The agreements under which the mine was being operated did not require the purchaser to extract or to pay for any minimum quantity of ore each year, and the amounts actually extracted from the mine varied widely in the years involved. The Court held, 283 U.S. at 413, that the sale of the taxpayer's interest in the mine in exchange for this highly contingent royalty agreement was an open transaction because the royalty payments were "wholly contingent upon facts and circumstances not possible to foretell with

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over their life expectancies, as determined pursuant to Section 1.72-9 of the Treasury Regulations on Income Tax. As applied to the annuity payable to petitioner Willard W. Garvey (see note 3, *supra*), it would appear that petitioner Willard Garvey conceded that he was required to report $212,369 each year as annuity income, and that at the end of his life expectancy of 26.3 years he would have been required to report a total of $5,521,077 in capital gain (*i.e.*, the fair market value of the property transferred, namely, $7,628,231, less his basis of $2,107,154) (Pet. App. 34a). Petitioners contend, however, that instead of reporting this gain pro rata as part of each annuity payment, they are entitled to report only the ordinary income taxable under Section 72, and to receive the remainder of each annuity payment tax free until they have recovered their entire basis in the property (Pet. 3, 5-7). As applied to the annuity payable to Willard Garvey, each annuity payment of $502,416 would be reduced by ordinary income of $212,369, leaving a balance of $290,047 (see note 3, *supra*). Instead of reporting $209,927 of this amount as capital gain in each year, petitioners contend that Willard Garvey is entitled to receive the entire $290,047 tax free until the total so received equals his basis of $2,107,154. By dividing the basis of $2,107,154 by the annual recovery rate of $290,047, it appears that petitioner Willard Garvey would obtain a tax deferral of approximately 7.26 years before paying *any* capital gains tax on the purchase of his annuity under the open transaction doctrine. Comparable figures for each of the other petitioners in this case are as follows: Jean K. Garvey, 8.81 years; James S. Garvey, 9.78 years; Shirley F. Garvey, 6.52 years; H. Bernerd Fink, 5.24 years; Ruth G. Fink, 7.04 years; George A. Lincoln, 5.38 years; and Olivia G. Lincoln, 8.75 years.

anything like fair certainty. The promise was in no proper sense equivalent to cash. It had no ascertainable fair market value." As the court of appeals pointed out (Pet. App. 9a), the annuities involved in the present case were totally different. They were payable in a fixed amount each year, contingent only upon the survival of the annuitant and the solvency of the obligor. The possibility of loss through insolvency and default by the obligor is, of course, present to some degree in any deferred payment transaction, but the receipt of notes or other evidences of indebtedness has never been considered, without more, to be a justification for resort to the open transaction doctrine. *Campbell* v. *United States*, 661 F.2d 209, 215 (Ct. Cl. 1981); *Warren Jones Co.* v. *Commissioner*, 524 F.2d 788, 793-794 (9th Cir. 1975); *Clodfelter* v. *Commissioner*, 426 F.2d 1391, 1393-1395 (9th Cir. 1970); *Bruce* v. *United States*, 254 F. Supp. 816, 818-819 (S.D. Tex. 1966), aff'd, 370 F.2d 569 (5th Cir.), cert. denied, 386 U.S. 1030 (1967).

The uncertainties inherent in the survival of an individual annuitant likewise do not support petitioners' claim that they should be permitted to resort to the open transaction doctrine of *Burnet* v. *Logan*, in reporting their gains on these private annuities. As the court of appeals pointed out (Pet. App. 9a), the allocation between return of capital and annuity income under Section 72 is based on actuarial proration of each payment and reflects a congressional preference for uniformity of tax liability and prompt collection of the revenue over the "wait and see" approach inherent in the open transaction doctrine. Although Section 72 does not explicitly deal with the tax treatment of gain arising from the purchase of such an annuity, the Claims Court correctly recognized (Pet. App. 44a) that prorating the gain over the petitioners' respective life expectancies is "more in keeping with the statutory scheme" than deferring

capital gains tax altogether until each annuitant has recovered his entire basis in the property transferred in exchange for his annuity.

2. Petitioners rely on the legislative history of the 1954 Code, in particular on the explanation given in H.R. Rep. 1337, 83d Cong., 2d Sess. A26 (1954), for a proposed Section 1241. That provision would have included the value of a private annuity contract in the amount realized on the transfer of property in exchange for such a contract. Hence, petitioners argue that their position is supported by the fact that the Senate Finance Committee deleted the proposed section from the bill, and that later the Conference Committee adopted the Senate version and the House receded from its proposal. S. Rep. 1622, 83d Cong., 2d Sess. 116 (1954); H.R. Conf. Rep. 2543, 83d Cong., 2d Sess. 71 (1954). This reliance is misplaced. As the House Report makes clear, the proposed Section 1241 would have taxed the *entire* amount of the gain to the transferor in the year of sale — a much more drastic acceleration of the recognition of capital gain than the proration required by Rev. Rul. 74. The Senate and the Conference Committee expressed a preference for further study before adopting such a rule. With respect to proration, however, as the Claims Court explained (Pet. App. 42a-44a), the legislative history of Section 72 of the Code shows that Congress was seriously dissatisfied with the "erratic" tax treatment accorded to annuity payments under the 1939 Code and abandoned it in favor of a provision spreading the tax free portion of the annuity evenly over the annuitant's lifetime. H.R. Rep. 1337, *supra,* at 10, A21; S. Rep. 1622, *supra,* at 10, 171-172. Thus, to the extent that the legislative history of the 1954 Code provides any guidance on the issue in this case it supports our view that the gain should be allocated over the annuitant's life expectancy; it does not advance petitioners' claim that they

should enjoy a "tax holiday" lasting from five to nine years while they recover their bases (see notes 3 and 5, *supra*).[6]

3. Finally, petitioners' claim that the Claims Court has misapplied the holding of this Court in *United States* v. *Davis*, 370 U.S. 65, 71-72 (1962), is without foundation. In *Davis*, this Court rejected the taxpayer's claim that the release of his wife's inchoate marital rights had no ascertainable market value on the ground that the taxpayer had surrendered stock having an ascertainable market value in exchange for the release, and there was a well established principle of law holding that the values of two properties exchanged in an arms-length transaction are presumed to be equal. *Philadelphia Park Amusement Co.* v. *United States*, 126 F. Supp. 184, 189 (Ct. Cl. 1954). Thus, in *Davis*, the value of the release the taxpayer received in his divorce settlement was held to be equal to the value of the stock he surrendered to obtain that release. Similarly, in the present

[6]Similarly, the decisions of the Tax Court in *Estate of Bell* v. *Commissioner*, 60 T.C. 469, 474-475 (1973), and *212 Corp.* v. *Commissioner*, 70 T.C. 788, 802-803 (1978), did not, as petitioners suggest, reject the open transaction doctrine solely on the basis of the fact that, in those cases, the annuities were secured (Pet. 12-13). In both of those cases, the court held that a secured private annuity was property which could be valued according to the Commissioner's annuity tables in Treasury Regulations on Estate Tax § 20.2031-7(f), and that the gain realized on the transfer of appreciated property in exchange for such an annuity was taxable in the year of the transfer. *Estate of Bell*, 60 T.C. at 475; *212 Corp.*, 70 T.C. at 802-803. This latter result was not sought by the Commissioner in those cases and is not consistent with the approach of Rev. Rul. 74, *supra;* and it was this incidental holding, not material here, that provoked the dissents to which the petitioners refer (Pet. 12-13). Indeed, Judge Simpson, in his dissent in *Estate of Bell*, 60 T.C. at 479, characterizes the rule of *Burnet* v. *Logan*, as "manifestly inconsistent with the objective of section 72," and goes on to suggest a method of proration that would result in the taxation of a portion of the capital gain each year, beginning with the first annuity payment.

case, the Claims Court found that the petitioners had obtained appraisals showing the fair market value of the property they transferred in exchange for their respective private annuities (Pet. App. 34a). The amount of the annuity to be paid to each of the petitioners was derived directly from the appraised fair market value of the transferred property by applying the annuity factors contained in Treasury Regulations on Estate Tax § 20.2031-7(f) (see note 3, *supra*). Thus, the principle announced in *Davis*, that the release should be presumed to be equal in value to the property surrendered in exchange for it, is applicable *a fortiori* to this case where the parties actually used that principle in arriving at an appropriate annuity payment.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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AUGUST 1984

DOJ-1984-08